

Information Gathering Hearing Relating to Insurer Surplus Office of Insurance Commissioner

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Tim Barclay



A MILLIMAN GLOBAL FIRM

Milliman

Consultants and Actuaries

STATE OF WASHINGTON



OFFICE OF
INSURANCE COMMISSIONER

Definition

Reserve – An amount to fulfill future obligations and unpaid liabilities already incurred.

Examples:

- Policy Reserves such as pro-rata unearned premium reserves and additional reserves for level-premium policies
- Claim reserves include amounts necessary to cover payments on claims already incurred
- Expense liabilities include amounts necessary to pay expenses and taxes incurred prior to the annual statement date



Definition

Surplus – Excess of assets over liabilities.

For purposes of this discussion, using the term “surplus” to be the same as equity or net worth. In some other contexts, equity can be segmented into capital and unassigned funds (surplus).

Sources of surplus

- Pricing margins
- Gains from investment earnings
- Gains from favorable morbidity



Surplus

Conflicting Needs for Surplus:

- Protect against unforeseen circumstances
- Satisfy requirements of regulators, rating agencies, policy owners, shareholders, or other outside evaluators

As surplus shrinks:

- Equity growth and return on invested capital increase
- Cost of coverage goes down
- The probability of insolvency increases



Layers of Surplus

- Cash flow surplus – satisfy existing contractual obligations in the event of unexpected contingencies
- Solvency surplus – book value surplus needed to maintain statutory solvency in the event of unexpected contingencies
- Target surplus – an amount of surplus to cover the above issues and to reduce the probability of surplus levels falling below established minimums (varies based on management's level of comfort and business forecast)
- Vitality surplus – capital amounts exceeding management's target surplus level investments, new business diversifications, or other enterprises outside the normal operating plan



Definition

Risk-Based Capital (RBC) – Formula developed by the National Association of Insurance Commissioners (NAIC) used to establish minimum surplus requirements beyond necessary reserve requirements

Five components:

H-0: Asset default risk, affiliates

H-1: Asset default risk, other

H-2: Insurance pricing/underwriting risk

H-3: Credit risk

H-4: Miscellaneous business risks



RBC Levels

Company Action Level

- $CAL = 200\% ACL$
- If $RBC < CAL$, company must notify the insurance commissioner of the corrective actions it plans to take to increase capital

Regulatory Action Level

- $RAL = 150\% ACL$
- If $RBC < RAL$, insurance commissioner will issue an order specifying the corrective actions to be taken



RBC Levels

Authorized Control Level (ACL)

- If $RBC < ACL$, insurance commissioner can take whatever regulatory action is necessary to protect the interests of the policyholders, including taking control of the company

Mandatory Control Level

- $MCL = 70\% ACL$
- If $RBC < MCL$, insurance commissioner required to place the company under regulatory control



Maximum Surplus Considerations

- RBC designed to monitor minimum surplus
- BCBS Association Early Warning Monitoring Level of 375% ACL
- Lewin Study suggests 900% ACL
- Hawaii limits surplus to 50% of annual claims and expenses
- Michigan limits surplus to 1,000% ACL
- Several states have considered implementation and have not done so

